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SIPDIS

TREASURY FOR INTERNATIONAL AFFAIRS - CPLANTIER

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SUBJECT: IMF CRITICISM OF TURKEY COINCIDES WITH PRESIDENT  
SEZER'S VETO OF CENTRAL BANK GOVERNOR NOMINATION

REF: A) ANKARA 1528; B) ANKARA 1409

1. (SBU) SUMMARY: TURKISH MARKETS SUFFERED A DOUBLE DOSE OF BAD NEWS OVER THE WEEKEND. ALTHOUGH PM ERDOGAN AND MINISTER BABACAN MADE REASSURING STATEMENTS ABOUT A NEW NOMINATION AND POLICY CONTINUITY, PRESIDENT SEZER'S VETO OF THE GOVERNMENT'S NOMINEE TO BE GOVERNOR OF THE CENTRAL BANK PROLONGED MARKET WORRIES ABOUT WHO WILL BECOME GOVERNOR AND HOW INDEPENDENT HE WILL BE. SEPARATELY, IMF MANAGING DIRECTOR RATO PUBLICLY CRITICIZED TURKEY'S RECENT VAT RATE CUT AND CIVIL SERVICE SALARY HIKE AS VIOLATIONS OF TURKEY'S IMF AGREEMENT. THE IMF RESREP TOLD US THE FUND WAS ALSO CONCERNED ABOUT OTHER FISCAL MEASURES UNDER CONSIDERATION. ALTHOUGH THE MARKET SELL-OFF WAS RELATIVELY MILD, THE CONTINUING CONFUSION OVER THE CENTRAL BANK GOVERNOR AND INCREASING PROBLEMS WITH THE IMF ARE ERODING THE GOT'S CREDIBILITY ON ECONOMIC POLICY. END SUMMARY.

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SEZER VETOES GOT NOMINEE  
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12. (SBU) ON SATURDAY, MARCH 25, THE GOVERNMENT ANNOUNCED THAT PRESIDENT SEZER HAD REJECTED A PROPOSED DECREE NAMING ADNAN BUYUKDENIZ TO BE CENTRAL BANK GOVERNOR AND MEHMET SIMSEK AND BIROL AYDEMIR TO BE VICE-GOVERNORS. NEITHER THE PRESIDENCY NOR THE PRIME MINISTRY DISCLOSED THE PRESIDENT'S REASONING, BUT THE PRESS SPECULATED THAT THE PRESIDENT'S REJECTION WAS DUE TO "INAPPROPRIATENESS" OF THE NOMINATIONS. IN BUYUKDENIZ' CASE, PRESS AND ANALYSTS ARE SPECULATING SEZER REJECTED THE MANAGING DIRECTOR OF AL-BARAKA TURK BECAUSE A) HIS WIFE WEARS A HEAD SCARF, AND B) THE CEO OF AN INTEREST-FREE ISLAMIC BANK IS POORLY PLACED TO DIRECT INTEREST RATE POLICY.

13. (SBU) THE VICE-GOVERNOR NOMINATIONS MAY HAVE BEEN REJECTED FOR TECHNICAL REASONS: DEUTSCHE BANK ANALYST TEVFIK AKSOY WROTE THAT THE NOMINATIONS NEED TO BE SIGNED BY BOTH THE GOVERNMENT AND THE CENTRAL BANK GOVERNOR PRIOR TO SUBMISSION TO THE PRESIDENT, RAISING THE POSSIBILITY THEY WOULD BE RENOMINATED ONCE THE GOVERNORSHIP QUESTION IS RESOLVED. SIMSEK, A FORMER U.S. EMBASSY FSN, IS NOW AN ANALYST FOR MERRILL LYNCH IN LONDON AND IS MARRIED TO AN AMERICAN. THOUGH HE HAS ENJOYED GOOD RELATIONS WITH THE CURRENT GOVERNMENT, HE IS NON-POLITICAL AND HIS NOMINATION IS LIKELY TO BE WELL-RECEIVED BY MARKETS. AYDEMIR, CURRENTLY A STATE PLANNING ORGANIZATION (SPO) DEPUTY UNDER SECRETARY WHO STUDIED ECONOMICS IN THE U.S., IS CLOSE TO THE

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AKP GOVERNMENT, HAVING HELPED PREPARE THE AKP'S ECONOMIC PROGRAM BEFORE THE NOVEMBER 2002 ELECTIONS. AYDEMIR, IN MULTIPLE MEETINGS WITH US, COMES ACROSS AS BOTH A SERIOUS ECONOMIC TECHNOCRAT AND AN AK PARTISAN, WHO SOMETIMES SHARES SPO'S FRUSTRATIONS WITH IMF STRICTURES.

14. (SBU) THE DISORDERLY PROCESS OF SELECTING A REPLACEMENT FOR OUTGOING GOVERNOR SERDENECTI CONTINUES TO ELICIT CRITICISM FROM THE PRESS, MARKET ANALYSTS, OPPOSITION POLITICIANS AND THE BUSINESS ESTABLISHMENT. FOR EXAMPLE, OMER SABANCI, CHAIRMAN OF THE INFLUENTIAL TURKISH INDUSTRIALISTS ASSOCIATION (TUSIAD) OPENLY QUESTIONED THE IDEA OF REPLACING A SUCCESSFUL GOVERNOR LIKE SERDENECTI.

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ERDOGAN AND BABACAN TRY TO REASSURE  
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15. (SBU) FOLLOWING THE ANNOUNCEMENT, PRIME MINISTER ERDOGAN SAID THE GOVERNMENT WOULD MAKE ANOTHER NOMINATION. SPECULATION HAS INCREASED THE THE GOT WILL NOW NOMINATE UNDER SECRETARY IBRAHIM CANAKCI WHO, IS ONE OF THE FEW POTENTIAL CANDIDATES WHO NOT ONLY CLOSE TO THE AKP GOVERNMENT BUT IS ALSO RESPECTED BY THE MARKETS AND WHOSE WIFE DOES NOT WEAR A HEADSCARF. ERDOGAN'S ANNOUNCEMENT THAT THE GOVERNMENT WOULD GO FORWARD WITH ANOTHER NOMINATION IS SOMEWHAT REASSURING TO MARKETS. OTHERWISE, THEY MIGHT FEAR A SCENARIO IN WHICH THE GOT WOULD REACT TO SEZER'S VETO BY LEAVING ACTING GOVERNOR ERDEM BASCI IN PLACE. THE WEAKNESS OF HIS STATUS AS ACTING GOVERNOR WOULD HARDLY ENHANCE CENTRAL BANK INDEPENDENCE AND CREDIBILITY.

16. (SBU) ON SUNDAY, MINISTER BABACAN, WHO HAS BEEN KEEPING A LOWER PUBLIC PROFILE IN RECENT WEEKS, MADE REASSURING REMARKS ABOUT THE CONTINUITY OF POLICY. TAKING THE SAME LINE HIS DEPUTY, TREASURY UNDER SECRETARY CANAKCI HAD TAKEN

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WITH US PRIVATELY, BABACAN SAID THE REFORMS ARE INSTITUTIONALIZED AND NO LONGER DEPEND ON ONE INDIVIDUAL. BABACAN STROVE TO PUT RECENT EVENTS IN CONTEXT AND EMPHASIZED THE GOT COMMITMENT TO THE REFORM PROGRAM, INCLUDING CENTRAL BANK INDEPENDENCE, INFLATION TARGETING AND THE FLOATING EXCHANGE RATE REGIME. COMMENT: THERE IS SOME TRUTH TO THE BABACAN/CANAKCI LINE: THE SUCCESS OF THE POST-2001 DISINFLATION PROGRAM CREATES PRESSURE ON THE CENTRAL BANK TO CONTINUE. MOREOVER, THE INTRODUCTION OF FORMAL INFLATION-TARGETING THIS YEAR MAKES IT HARDER FOR THE BANK TO CHANGE POLICIES. ON THE OTHER HAND, BABACAN AND CANAKCI, IN THEIR DESIRE TO PAINT A POSITIVE PICTURE (REF B) ARE SERIOUSLY UNDERSTATING THE IMPORTANCE OF A STRONG, INDEPENDENT CENTRAL BANK GOVERNOR WHO CAN RESIST POLITICAL PRESSURES TO LOWER THE EXCHANGE RATE. END COMMENT.

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IMF CRITICISM  
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17. (SBU) ON FRIDAY, AFTER THE MARKETS CLOSED, IN AN UNRELATED DEVELOPMENT, IMF MANAGING DIRECTOR RODRIGO RATO MADE RARE PUBLIC COMMENTS CRITICAL OF TURKEY. RATO, IN ACAPULCO, SAID TURKEY NEEDED TO KEEP A STRONG PRIMARY SURPLUS TO BRING DOWN ITS HIGH PUBLIC DEBT BURDEN, AND THAT LOWERING TAX RATES AND BOOSTING CIVIL SERVICE SALARIES WAS NOT THE PATH TO REDUCING PUBLIC DEBT. RATO, LIKE THE ANONYMOUS IMF OFFICIAL QUOTED BY REUTERS EARLIER IN THE WEEK, SAID THE RECENT MEASURES WERE DEVIATIONS FROM TURKEY'S IMF PROGRAM. RATO MAY HAVE FELT THE NEED TO MAKE THIS POINT PUBLICLY, SINCE DEPUTY PRIME MINISTER ABDULLATIF SENER HAD ANGRILY REJECTED THE IMF OFFICIAL'S CLAIM THAT THE MEASURES WERE DEVIATIONS FROM THE PROGRAM. SENER SAID IT WAS THE GOVERNMENT'S PROGRAM, NOT THE IMF'S, AND INSISTED ON THE NEED FOR A "SOCIAL PILLAR" TO THE PROGRAM.

18. (SBU) EARLIER ON FRIDAY, BEFORE RATO'S COMMENTS, THE IMF RESREP HAD EXPRESSED CONCERNS TO US ABOUT A SERIES OF FISCAL

MEASURES EITHER PASSED (VAT RATE CUT FOR TEXTILES AND CIVIL SERVICE BONUSES) OR UNDER CONSIDERATION THAT UNDERMINE THE PROGRAM'S FISCAL STRATEGY. WHEREAS A CENTRAL PILLAR OF THE STRATEGY IS TO REDUCE LOOPHOLES AND EXEMPTIONS IN ORDER TO PERMIT GRADUAL LOWERING OF TURKEY'S TAX RATES, THE GOT SEEMS TO BE PRONE TO RETURNING TO ITS FORMER PENCHANT FOR MEASURES THAT WILL MAKE IT HARDER TO REDUCE RATES AND STILL MAINTAIN FISCAL BALANCES. THOUGH THE GOT MAY STILL RESIST THESE MOVES, THE RESREP WAS CONCERNED THAT PARLIAMENT MAY RESPOND SYMPATHETICALLY TO THE TURKISH INDUSTRIALISTS ASSOCIATION'S (TUSIAD) URGING TO SLOW DOWN THE PHASEOUT OF THE INVESTMENT ALLOWANCE UNDER THE CORPORATE INCOME TAX(CIT). THE GOT-PROPOSED, IMF-BLESSED VERSION OF THE CIT RATE REDUCTION WAS DEEMED AFFORDABLE ONLY BECAUSE IT PHASED OUT THE ALLOWANCE FOR CAPITAL INVESTMENTS, WHICH SKEWED THE TAX CODE IN FAVOR OF CAPITAL-INTENSIVE, RATHER THAN LABOR-INTENSIVE INVESTMENTS.

¶9. (SBU) THE RESREP WAS ALSO CONCERNED ABOUT PARLIAMENTARY MOVES TO ALLOW DEDUCTIBILITY OF INTEREST ON MORTGAGE LOANS IN THE NEW MORTGAGE LAW UNDER CONSIDERATION. IMF STAFF BELIEVE INTERNATIONAL EXPERIENCE SUGGESTS THE DEDUCTIBILITY OF MORTGAGE INTEREST IS NOT BEST PRACTICE. IN TURKEY'S CASE WOULD IT WOULD EAT INTO TAX REVENUES BY PROVIDING A NEW DEDUCTION WITHOUT ANY DIRECT POSITIVE EFFECT ON REVENUES. CAPITAL MARKETS BOARD CHAIRMAN CANSIZLAR ARGUED THE OPPOSITE CASE TO US, ASSERTING THAT THERE WOULD BE NO REVENUE LOSS BECAUSE OF THE BROADER POSITIVE EFFECT ON ECONOMIC GROWTH OVER THE MEDIUM TERM.

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NERVOUS MARKETS  
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¶10. (SBU) EVEN BEFORE THE RATO COMMENTS AND ANNOUNCEMENT OF SEZER'S VETO, THERE WAS A SELL-OFF IN TURKISH FINANCIAL MARKETS FRIDAY, WITH THE ISTANBUL STOCK EXCHANGE DECLINING 2.82% AND THE LIRA DOWN FROM 1.3387 PER DOLLAR TO 1.3473 AT THE CLOSE, ALTHOUGH THE YIELD ON THE BENCHMARK GOVERNMENT BOND REMAIN UNCHANGED. ON SATURDAY, WHEN SEZER'S VETO WAS ANNOUNCED, IT EMERGED THAT HE HAD INFORMED THE PRIME MINISTRY ON THURSDAY, MARCH 23, RAISING SUSPICIONS THAT SOME OF THE SELLING ON FRIDAY COULD HAVE BEEN SPARKED BY INSIDER KNOWLEDGE OF THE SEZER VETO.

¶11. (SBU) ON MONDAY, EQUITY MARKETS CONTINUED TO FALL, WITH

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THE IMKB 100 INDEX CLOSING DOWN 1.30%. THE LIRA, HOWEVER, APPRECIATED SLIGHTLY TO 1.3451 PER DOLLAR. GIVEN THE WEEKEND'S NEWS, EMRAH Eksi OF THE CENTRAL BANK MARKETS DEPARTMENT CONSIDERED THE MARKETS' REACTION TO BE MILD, AND ATTRIBUTED SOME OF THE SELLING TO OTHER NEWS, SUCH AS TELECOM ITALIA'S ANNOUNCEMENT IT WOULD WITHDRAW FROM A CELL PHONE JOINT VENTURE IN TURKEY.

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OUTLOOK  
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¶12. (SBU) DESPITE BABACAN'S ATTEMPT TO PUT A POSITIVE SPIN ON DEVELOPMENTS, RECENT EVENTS HAVE UNDERMINED BOTH THE GOVERNMENT'S CREDIBILITY ON ECONOMIC POLICY AND THAT OF THE CENTRAL BANK. ALTHOUGH THE SOCIAL SECURITY LEGISLATION IS FINALLY BEING DELIBERATED IN THE PLAN AND BUDGET COMMITTEE, UNLESS PARLIAMENT PASSES IT THIS WEEK, THE RESREP DOUBTED THE IMF WOULD SEND A MISSION UNTIL AFTER THE IMF/WORLD BANK SPRING MEETINGS, I.E. BEFORE MAY. ONCE A MISSION COMES, HE SAID THE FUND WILL BE IN THE DIFFICULT POSITION OF DECIDING WHETHER TO ALLOW WAIVERS FOR THE VAT RATE CUT AND THE CIVIL SERVICE BONUSES.

MCELDOWNEY